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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

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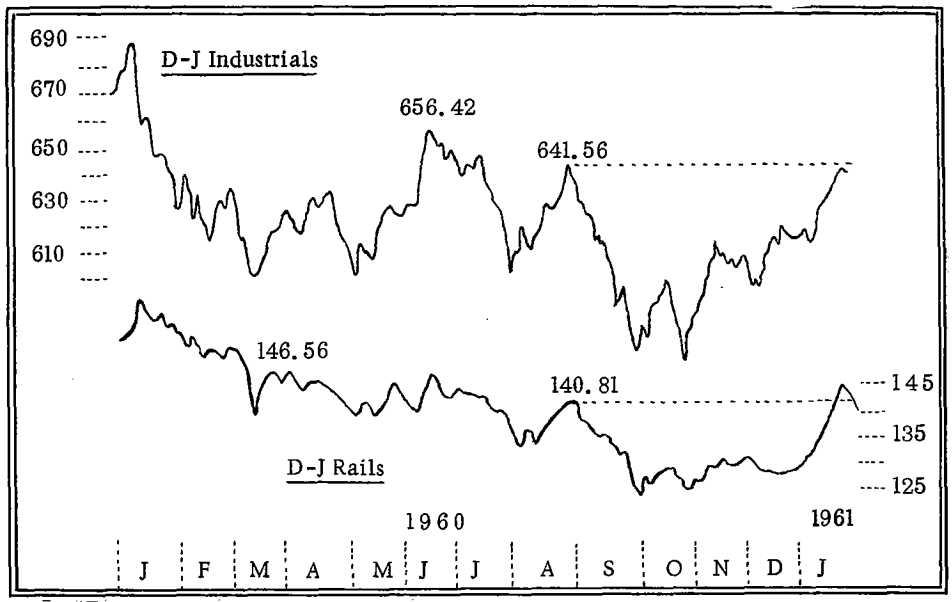
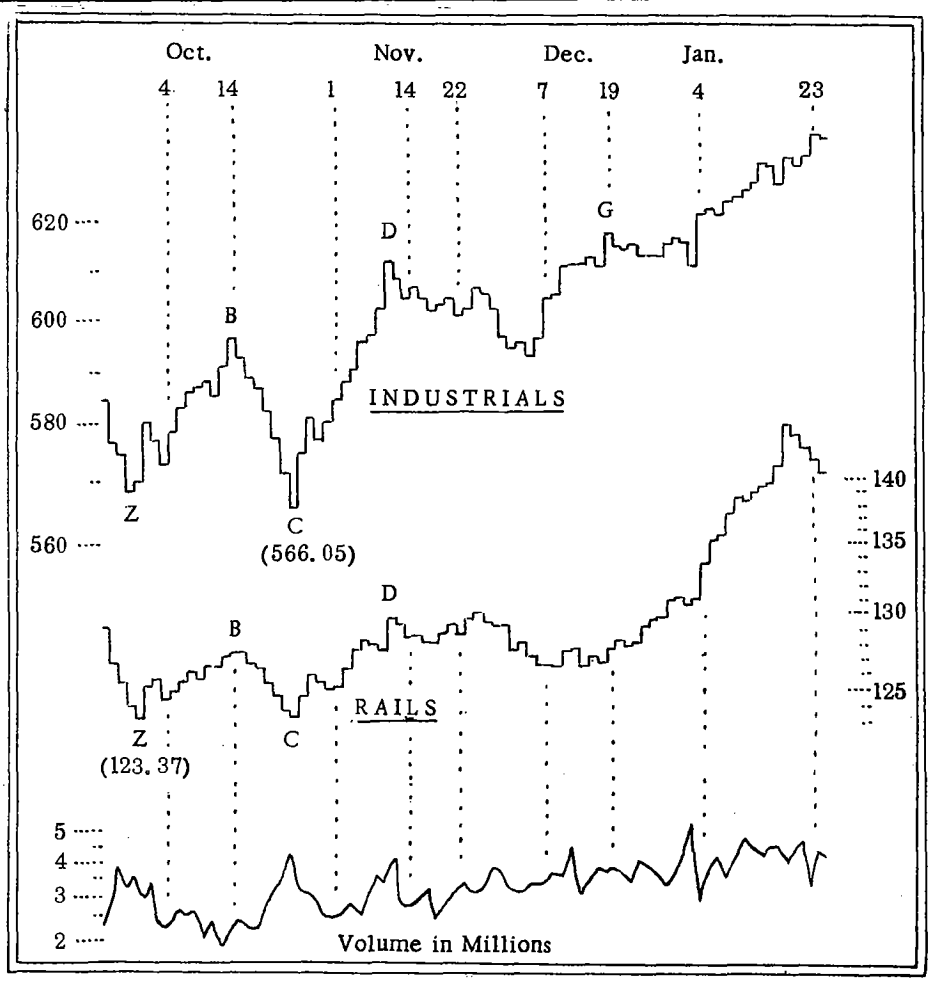
PRICE MOVEMENTS The top chart shows the daily price movements from January, 1960, to the present. In many ways the pattern of the Industrials and Rails during this period presents one of the most unusual and complex configurations in the 65 year history of the Averages. In March, 1960, the bear signal was given as both Averages violated secondary low points recorded in late 1959. Six months later (September) the bear market was reconfirmed as the two indicators again plunged to new lows. In September Rails touched an extreme low of 123.37; one month later Industrials sank to a bear market low of 566.05. From those levels the Averages turned up and embarked on an advance which has lasted to the present.

As of this writing Rails have rallied to a recovery high of 144.89 (January 18), a level which exceeded the Rail peak of August, 1960 (dotted line on chart). On January 23 Industrials established a recovery high of 639.82, but Industrials have failed (so far) to confirm by bettering their comparable August peak of 641.56. Although there is no time limit on the confirmation principle, it is well to remember that many important reversals have occurred in areas where one Average persistently refused to confirm the indications of the other. If both Averages now turn down (prior to an Industrial confirmation above the 641.56 August high), the price structure will



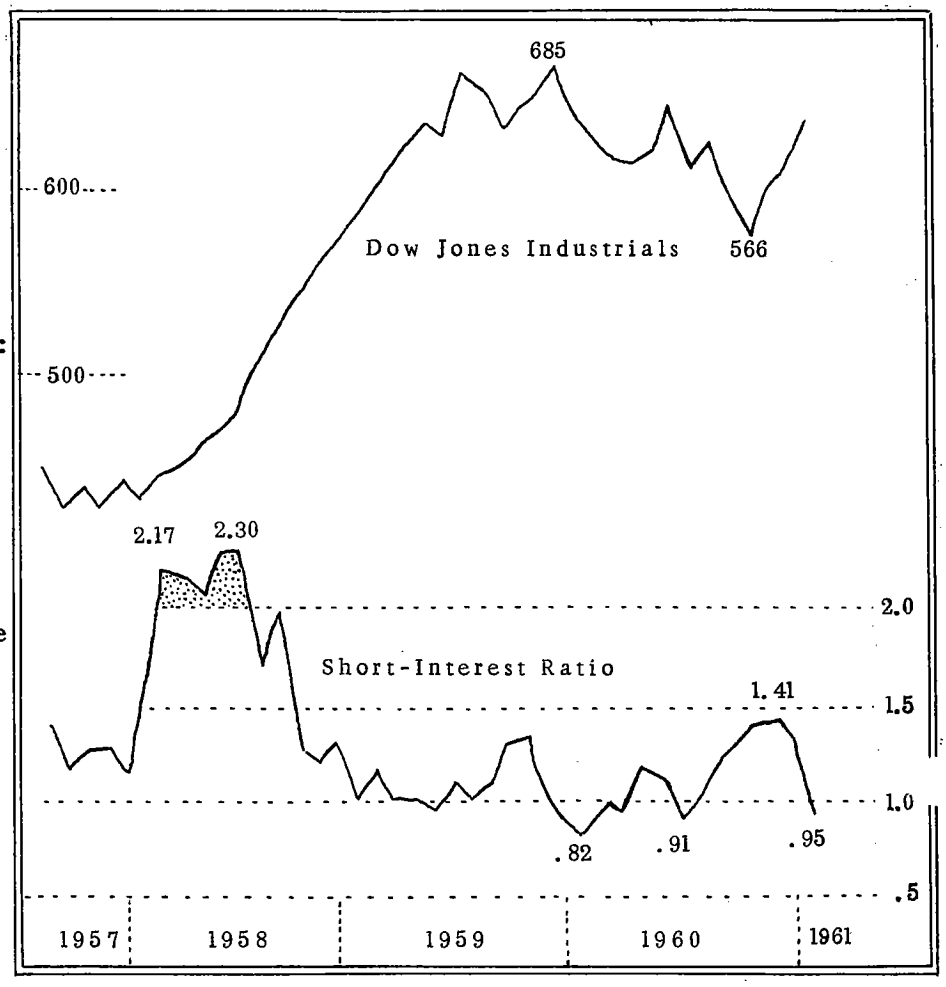


Far more important from the standpoint of preceding upside objectives, however, are the true secondary peaks of 656.42 (Industrials, June, 1960) and 146.56 (Rails, March, 1960). A bettering of these levels would assume a bullish significance second only in importance to an actual bettering of the 1959-60 highs.

Turning to the near-term picture, it is worth noting that over the past few months volume has held at the highest rate since late 1958. Thus a tremendous amount of "steam" has been generated under the market "boiler", and it is particularly interesting to observe that this heavy volume began appearing shortly after the rebound from the September-October lows. Since November 15, 1960, daily volume has averaged 3.7 million shares, and this underscores the excited almost frantic character of the advance. A second point worth considering is the nearly vertical rise in the Rail Average. Between December 13 and January 18 Rails advanced on 20 out of the 24 trading days. Such Rail action (except at the outbreak of war) is seldom seen and is all the more significant because Rails tend to be a speculative (not an investment) medium.

From the short-term standpoint the elements of possible danger (aside from the actual extent and duration of the advance so far) would be (1) a refusal of Rails to better the January 18 high of 144.89, and (2) a refusal of Industrials to confirm by bettering their August high of 641.56. On January 20 and 23 (Friday and Monday) Rails diverged, declining as Industrials rallied. On January 24 both Averages retreated as volume of trading continued to hold above the 4 million share mark. The formation of a descending zig-zag in both Averages would be the first hint of a reversal in the minor (and perhaps secondary) trend.

SHORT INTEREST RATIO (S.I.R.) One of the most valuable of the technical indicators is the S.I.R. The S.I.R. is computed as follows: divide the total short position on the N.Y. Stock Exchange by the average daily volume taken over the sa one month period. In general, the lower the average daily volume and the higher the total short interest the more bullish the situation. Conversely, the lower the short interest and the higher the average daily volume the greater the technical deterioration.



The short seller is subject to two possible sources of pressure: (1) a rising market, which obviously entails both psychological tension and potential financial loss, and (2) a market that holds or declines on contracting volume. Every short seller is speculating for a big drop on heavy or liquidating volume. If prices hold or decline slightly on low volume, the short seller is trapped, and his inclination is to close out his commitments. A rising market implies that the bears are on the run; a steady or gradually declining market with low volume implies that the bears are trapped. In the latter case, the S.I.R. will rise, indicating that the technical position of the

market is strengthening.

I consider the S.I.R. to be a particularly important indicator for the following reasons: (1) It has a lengthy history (my own statistics on the S.I.R. go back to 1932), (2) It requires interpretation (the S.I.R. cannot be "read" mechanically), (3) It has not gathered a large following (few investors use or understand the S.I.R.), and (4) It is based on fundamental forces (the S.I.R. is not a market "gimmick").

Like the Averages, the S.I.R. is not always "talking". But when it does talk the story is usually well worth listening to. For instance, in March, 1958, the S.I.R. climbed to a seldom seen high of 2.17 (see chart). Four months later in July, 1958, the S.I.R. rose to an incredible 2.30. From March through July, 1958, or for five consecutive months the S.I.R. held in the extremely bullish 2.0-plus zone (dotted area on chart). This high reading implied that a tremendous technical base was being built, a base strong enough to support a sustained market advance.

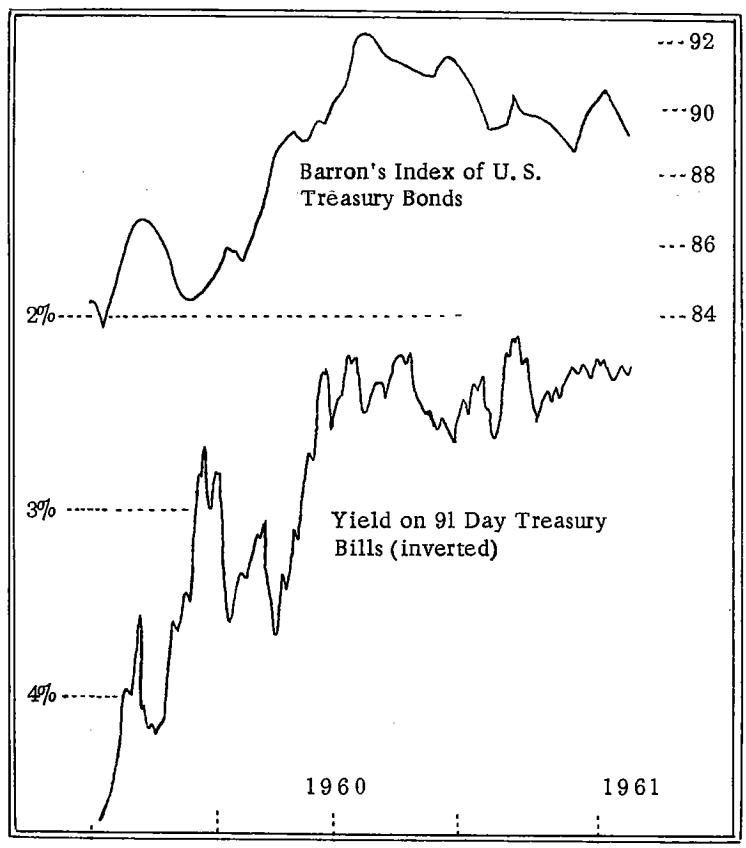
In January, 1960, the S.I.R. dropped to a six year low of .82. From this point the market tumbled in one of the worst January declines on record. The S.I.R. turned up for three months, then dropped to a June, 1960, low of .91. The .91 low coincided with the start of the 90 point Industrial decline of June through October, 1960.

During the period of June to November, 1960, the S.I.R. rose for five consecutive months, reaching a rather unimpressive peak of 1.41. Nevertheless, the June-November rise in the S.I.R. preceded the stock market advance (which began in September) by three full months.

Then in December, 1960, the S.I.R. reversed direction, sinking from the November peak of 1.41 to a December figure of 1.32. This month (January) marked the second consecutive drop in the S.I.R. The latest figures show that during the period of December 16 to January 15 the total short interest dropped from 4.4 million to 3.7 million shares. This put the S.I.R. at a seven month low of .95. The November peak of only 1.41 and the January reading of .95 must both be considered minus factors in the current technical picture.

MONEY, MONEY The relentless outflow of gold plus the more recent hopes for an economic upturn have caused investors to cast a wary eye on the Treasury bond market. Since mid-1960 the trend of Treasury bonds has been down (see chart) , and this reflects the unwillingness of investors to become "locked into" the current situation. Because of the steady gold outflow there is always the chance that the "Fed" may have to raise interest rates to stop the movement of "hot money". Such action, of course, would send the bond market lower (particularly the longer term maturities). Higher interest rates could also come if the economy suddenly improved.

The chart shows the movements of Barron's Treasury bond index superimposed upon the yield of the 91-day Treasury bills (the shortest and most liquid of all Treasury obligations). So far, since mid-1960 the bills have held steady in the 2.10 to 2.60% yield zone. This steadiness in bill yields against a declining bond market underscores the big investors' desire to remain liquid at this time.



The new Executive order forbidding Americans to hold gold abroad means that U. S. citizens have now been deprived of the right to hedge their savings against a possible "watering" of the dollar (devaluation). Pick's Currency

Yearbook notes that of 90 countries in the world, all but 19 permit their citizens to hold gold. Of the 19 exceptions only 6 can be considered "large" or important nations. These six are China, Russia, East Germany, Hungary, the United Kingdom and the U. S.

VACUUMS The market is subject to two types of vacuums; one is fundamental and the other is technical. A fundamental vacuum may occur (1) during a period of extended divergence between earnings and price movements. For instance, during the unusual period of 1946 to 1949 earnings on the D-J Industrials improved steadily, yet the market would not respond. For a good many complex reasons public psychology during the 1946-49 period was not conducive to the formation of a major bull market. This created a fundamental vacuum which was not rectified until 1949. In June, 1949, the great bull market of 1949-59 was born.

In the current situation earnings on the D-J Industrials have been in a downtrend since late 1955 (see Letter 130). Thus another fundamental vacuum has been formed. Sooner or later this vacuum must be filled, and the longer the time lag and the greater the disparity the more likelihood that the vacuum will be filled with accompanying violence.

A technical vacuum may occur during a period of extended divergence between the D-J Industrials and (1) the D-J Rails or (2) the breadth (advance-decline ratio). Technicians know that sooner or later all three of these indicators must get "in gear". Often a technical divergence will foreshadow or coincide with a fundamental vacuum. This happened in 1929. In June of that year business hit a peak and turned down; in July market breadth turned down; in September the D-J Industrials and Rails turned down.

The ideal market, of course, is one in which Industrials, Rails and breadth are moving in gear, and all three are moving ahead of forthcoming fundamentals. Unfortunately for market idealists, however, this situation does not always prevail

FROM CANADA My friend Iain Fraser (199 Bay St., Toronto) now publishes a beautiful book of 750 stock charts (weekly price movements - 1955 to the present). In glancing over the book two things strike me. One is the number of collapses in speculative Canadian stocks; the second is the strength in silver issues. Commenting on the first, Mr. Fraser writes: "The first 83 pages cover our more speculative issues. If you can spare the time I suggest you go through these charts, and I think you will be somewhat flabbergasted. The last three years have produced an incredible shakeout in our lower priced stocks."

I would not be adverse to buying silver stocks at this time, however. Consumption of silver is now outstripping production throughout the world, some of the reasons being (1) the rise of the vending machines and silver coin usage, (2) booming use of silver in electr components, photography, jewelry, etc., (3) France's creation of the new "heavy frank". United Keno Hill Mines is the "blue chip of the Canadian silvers, and the chart shows that Keno has been under accumulation since 1957. It recently broke out of its entire 1955-60 price range and is in a position for buying. Two speculative silvers, Siscoe and Highland Bell are also in favorable patterns. The chart of Siscoe is representative of both stocks and shows an impressive pattern of accumulation.

(Written Wednesday, January 25th - 2 P. M.)